THE REPUBLICAN STUDY COMMITTEE
THE BUDGET & SPENDING TASK FORCE
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Weekly Report – October 29, 2013

CBO Backpedals on Medicaid Age Increase

- Last week, the Congressional Budget Office (CBO) walked back its 2012 report on raising the Medicare eligibility age to 67 (from 65). That report showed savings of $113 billion over 10 years.
- The new report shows savings of only $19 billion. CBO reports that the dramatic downward revision is the result of more careful analysis of first- and second-year Medicare recipients (who are healthier and cheaper to cover than older cohorts).
- Although the savings are smaller than originally projected, the reform still makes sense in light of changing demographic trends. The average life expectancy when Medicare was created in 1965 was 70.2 years. In 2010, average life expectancy was 78.4 years. Thus, the average covered period has grown from 5.2 years to 13.4 years.

Budget Conference Committee

- The budget conference committee – all 29 House and Senate Members – will hold its first public meeting on Wednesday, October 30.
- Republican Members have focused their public comments on finding an appropriations level and establishing a framework for tax reform.
- Publically, members of the conference committee have expressed skepticism that anything beyond setting spending levels and establishing a framework for tax reform is within reach.
- If appropriations continue at current levels, a $20 billion sequestration cut taken almost exclusively from defense spending will go into effect in mid-January.

Congressional Budget Office (CBO) Spending Proposals

- CBO has previously scored dozens of policy proposals and their effect on the deficit.
- Choices for Deficit Reduction – November 2012 – http://www.cbo.gov/publication/43692 - Comprehensive report of prior CBO analysis to reduce the deficit.
- Reducing the Deficit – March 2011 – http://www.cbo.gov/publication/22043 - Evaluates spending and revenue options.
- Social Security Policy Options – July 2010 – http://www.cbo.gov/publication/21547 - Scores options such as increases in the Social Security payroll tax, decreases in benefits, increases in the retirement age, and COLA adjustments.

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OPINION – October 28, 2013

John B. Taylor: Economic Failure Causes Political Polarization –*Americans worried about sluggish growth and high unemployment are not extremists.*

It is a common view that the shutdown, the debt-limit debacle and the repeated failure to enact entitlement and pro-growth tax reform reflect increased political polarization. I believe this gets the causality backward. Today's governance failures are closely connected to economic policy changes, particularly those growing out of the 2008 financial crisis.

The crisis did not reflect some inherent defect of the market system that needed to be corrected, as many Americans have been led to believe. Rather it grew out of faulty government policies.

In the years leading up to the panic, mainly 2003-05, the Federal Reserve held interest rates excessively low compared with the monetary policy strategy of the 1980s and '90s—a monetary strategy that had kept recessions mild. The Fed's interest-rate policies exacerbated the housing boom and thus the ensuing bust. More generally, extremely low interest rates led individual and institutional investors to search for yield and to engage in excessive risk taking, as Geert Bekaert of Columbia University and his colleagues showed in a study published by the European Central Bank in July.

Meanwhile, regulators who were supposed to supervise large financial institutions, including Fannie Mae and Freddie Mac, allowed large deviations from existing safety and soundness rules. In particular, regulators permitted high leverage ratios and investments in risky, mortgage-backed securities that also fed the housing boom.

After the housing bubble burst the value of mortgage-backed securities plummeted, putting the solvency of the many banks and other financial institutions at risk. The government stepped in, but its ad hoc bailout policy was on balance destabilizing.

Whether or not it was appropriate for the Federal Reserve to bail out the creditors of Bear Stearns in March 2008, it was a mistake not to lay out a framework for future interventions. Instead, investors assumed that the creditors of Lehman Brothers also would be bailed out—and when they weren't and Lehman declared bankruptcy in September, it was a big surprise, raising grave uncertainty about government policy going forward.

The government then passed the Troubled Asset Relief Program which was supposed to prop up banks by purchasing some of their problematic assets. The purchase plan was viewed as unworkable and financial markets continued to plummet—the Dow fell by 2,399 points in the first eight trading days of October—until the plan was radically changed into a capital injection program. Former Treasury Secretary Hank Paulson, appearing last month on CNBC on the fifth anniversary of the Lehman bankruptcy, argued that TARP saved us. Former Wells Fargo CEO Dick Kovacevich, appearing later on the same show, argued that TARP significantly worsened the crisis by creating even more uncertainty.

In any case, the crisis ended, but rather than simply winding down its short-term liquidity facilities the Fed continued to intervene through massive asset purchases—commonly called quantitative easing. Many outside and inside the Fed are unconvinced quantitative easing is meeting its objective of spurring economic growth. Yet there is a growing worry about the Fed's ability to reduce its asset purchases without market disruption. Bond and mortgage markets were roiled earlier this year by Chairman Ben Bernanke's mere hint that the Fed *might* unwind.

The crisis ushered in the 2009 fiscal stimulus package and other interventions such as cash for clunkers and subsidies for first-time home buyers, which have not led to a sustained recovery. Crucially, the actions taken during the immediate crisis set a precedent for giving the federal government more power to intervene and regulate, which has added to uncertainty.

The Dodd-Frank Act, meant to promote financial stability, has called for hundreds of new rules and regulations, many still unwritten. The law was supposed to protect taxpayers from bailouts. Three years later it remains unclear how large complex financial institutions operating in many different countries will be "resolved" in a crisis. Any fear in the markets about whether a troubled big bank can be handled through Dodd-Frank's orderly resolution authority can easily drive the U.S. Treasury to resort to another large-scale bailout.

Regulations and interventions also increased in other industries, most significantly in health care. The mandates at the core of the Affordable Care Act represent an unprecedented degree of control by the federal government of the activities of businesses and individuals, adversely affecting incentives to hire and work and eventually worsening the federal-budget outlook.

Federal debt held by the public has increased to 73% of GDP this year from 41% in 2008—and according to the Congressional Budget Office, it will rise to more than 250% without a change in policy. This raises uncertainty about how the debt can be brought under control.

Despite a massive onslaught of legislation and regulation designed to foster prosperity, economic growth remains low and unemployment remains high. Rhetoric aside, many both inside and outside the government quite reasonably seek to return to the kinds of policies that worked well in the not-so-distant past. Claiming that one political party has been hijacked by extremists misses this key point, and prevents a serious discussion of the fundamental changes in economic policies in recent years, and their effects. *Mr. Taylor is a professor of economics at Stanford University, a senior fellow at the Hoover Institution, and a former Treasury undersecretary for international affairs.*